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TAGS: EFIN ECON TU
SUBJECT: CONTINUED SELL-OFF IN TURKISH MARKETS

REF: A. ANKARA 2456
¶B. ANKARA 2359

¶1. (Sbu) Summary: The sell-off continued in Turkish markets this week, with bursts of nervous selling Thursday and Friday driving the lira to new lows for the year. A bad week for global emerging markets was exacerbated in the Turkish case by increased tension between the Government and the military over legislation to make it easier for students from religious schools to enter university. Though interest rates continue to rise, they remain manageable for the Turkish Treasury. After the markets closed Friday, the Central Bank announced a worse-than-expected February Current Account deficit of $2.066 billion. End Summary.

¶2. (Sbu) Turkish Financial markets had another bad, but not disastrous, week. The market volatility that began with the April 24 Cyprus referendum and the moved-up expectations of a U.S. interest rate hike continued this week, and was helped along both by global market and local developments. According to analysts and the Central Bank Governor, the main global market trend depressing Turkish markets was the negativity in the global market in emerging market bonds, driven by the drumbeat of information out of the U.S. raising fears of a Fed rate hike sooner rather than later: the Fed statement earlier this week followed by lower than expected applications for unemployment compensation on Thursday and higher than expected non-farm payrolls on Friday.

¶3. (Sbu) Local developments hardly helped the markets' mood. Even though the inflation data for April announced Monday, showed that 12-month CPI was already, at 10.18 percent, below the year-end target of 12 percent, Citigroup Istanbul's economist Olgay Bukkayali told econoff that markets seemed to focus more on the surprisingly sharp month-on-month jump in agricultural prices and in the Wholesale Price Index. The month-on-month WPI jump was worse than expected at 2.65 percent, although the 12 month change in the WPI was still only 8.91 percent. Consequently, Monday was a bad day in the markets, with the Lira weakening from TL 1.420 at Friday's close to TL 1.458 at the close.

¶4. (Sbu) On Wednesday, Prime Minister Erdogan publicly floated the idea of reducing Turkey's crucial primary surplus target of 6.5 percent of GDP in 2005. Though certainly a negative for markets, the markets did not react sharply, perhaps because Central Bank Governor Serdengecti had earlier in the day implied Turkey needed a continued IMF role next year. Markets were also focused on the U.S. unemployment application and non-farm payroll data on Thursday and Friday, respectively.

¶5. (Sbu) Most rattling of all, however, was the sudden uptick in tension between the GOT and the military over the GOT's moving ahead on legislation that would make it easier for graduates of Imam Hatip high schools, which focus on religious education, to enter university. Though the political dimension of these developments is being reported septel, the military's issuance of a strong warning statement late Thursday clearly unsettled the markets. A worried Central Bank Governor Sureyya Serdengecti told Econcouns Thursday evening that he had taken the unusual step of urging GOT ministers to withdraw the legislation to avoid market problems. He feared that Friday would be a bad day if tensions were not defused. Sure enough, in early morning trading Friday the equity market fell sharply and the TL fell from 1.463 mm to the USD at Thursday's close to TL 1.480 before stabilizing somewhat. Near the end of the day, the sell-off again took on a head of steam such that the TL ended

the day breaking the TL 1.5 barrier, reaching TL 1.51 mm per USD in after-hours trading. The IMKB 100 stock index ended the day 3.5 percent down, at 17,001.97. Today's sell-off happened in a context of very low transaction volumes, suggesting that most investors are still on the sidelines, even though those that are in the market are selling rather than buying.

¶6. (Sbu) The government securities market was not immune to the sell-off: The benchmark May 10, 2005 bond ended the week yielding 26.25 percent compared to 24.46 at the close last Friday. As these numbers suggest, the sell-off in government securities was not as dramatic as in the thinner and more volatile equity and foreign exchange markets. The tendency of Turkish banks, who dominate the government securities market, to buy to support the value of their portfolios, combined with reports that foreign holders of longer-dated TL assets are still holding on to them, may explain this more limited impact on fixed income markets.
¶7. (Sbu) In all three markets, however, the difference a month has brought is quite striking. One month ago, the TL was at 1.335 mm to the dollar and 1.615 mm to the Euro (vs 1.796 mm at the close May 7), the benchmark interest rate was only 21.91 percent and the stock market was around 20,000. Much as the market was in one of Turkey's "virtuous circles" for much of the past year, in the last month it has returned to a "vicious circle" pattern. During the virtuous circle period, the appreciation of the currency helps reduce inflation, causing interest rates to fall, and investors to keep betting on the currency rising and interest rates falling. During the vicious circle period, the momentum is in reverse. Not only, as several Istanbul analysts have explained to econoff, do investors "stop-loss" positions exacerbate the fall as they are forced to unwind their positions when the lira hits certain levels, but the fall in Turkish Eurobond prices generates margin calls on Turkish banks' external borrowings collateralized by Eurobonds. Huseyin Kelezoglu of HC Istanbul, who explained the latter phenomenon to econoff, said the fall in Turkish Eurobond prices also exacerbates Turkish banks' already significant open foreign exchange positions, i.e. the banks FX-deonominated liabilities exceed their FX-denominated assets. When the Eurobonds, which are FX-denominated assets fall in price, the banks have to sell more TL and buy FX to avoid going over exposure limits monitored by the bank regulators. This adds to the market pressure on the lira, exacerbating its fall.

¶8. (Sbu) If all this were not enough, after the markets closed Friday, the Central Bank announced a worse-than-expected Current Account Deficit for February of $2.066 billion. (Markets were expecting $1.532 billion).
The Current Account
Deficit announcement, and the unresolved Imam Hatip situation, set the stage for difficult market conditions on Monday. Some analysts, including Kelezoglu, believe the Central Bank could intervene to prevent excess volatility in the foreign exchange market. Unlike the Central Bank's several interventions to break the speed of the Lira's appreciation over the past year, intervening to support a falling lira will decrease rather than increase the Central Bank's foreign exchange reserves.

¶9. (Sbu) Despite the continued sell-off, it is important to note that the markets are nowhere near a crisis. The Turkish Treasury is not expected to have any difficulty rolling over its debt in the coming months. Because of the substantial fall in inflation and interest rates in the first quarter of 2004, current interest rate levels are already well below the projected average interest rate for the year of 29 percent, on which the Treasury's borrowing program and the GOT's budget are based. Moreover, the Treasury borrowed heavily from the domestic market in the first three months of the year, when conditions were favorable, given it some room for maneuver for the remainder of the year.

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